

**Supplemental Letter of Findings: 04-20091041**  
**Gross Retail Tax**  
**For the Years 2006, 2007, and 2008**

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**ISSUES**

**I. Test Cell Equipment – Gross Retail Tax.**

**Authority:** IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-4-1; IC § 6-2.5-5-3; IC § 6-2.5-5-4; IC § 6-2.5-5-5.1; IC § 6-2.5-5-6; IC § 6-2.5-5-40; IC § 6-3.1-4-1; IC § 6-8.1-5-1; [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-9](#); [45 IAC 2.2-5-10](#); [45 IAC 2.2-5-12](#); Indiana Dep't of State Revenue v. Interstate Warehousing, 783 N.E.2d 248 (Ind. 2003); Tri-States Double Cola Bottling Co. v. Dep't of State Revenue, 706 N.E.2d 282 (Ind. Tax Ct. 1999); Mynsberge v. Dep't of State Revenue, 716 N.E.2d 629 (Ind. Tax Ct. 1999); Indianapolis Fruit v. Dept. of State Revenue 691 N.E.2d 1379 (Ind. Tax Ct. 1998); Indiana Dept. of State Revenue v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); Sales Tax Information Bulletin 75 (October 2008); Sales Tax Information Bulletin 75 (September 2007).

Taxpayer argues that it is not subject to sales or use tax on the equipment used in its test cells.

**II. Electrical Generator – Gross Retail Tax.**

**Authority:** IC § 6-2.5-5-40.

Taxpayer states that it was not required to pay sales tax on the purchase of a generator because the generator is used, in part, to serve as a backup power source for its building and will be used in two research projects conducted within its test cells.

**STATEMENT OF FACTS**

Taxpayer is an Indiana corporation which elected "S Corporation" status. Taxpayer provides manufacturing, testing, and research and development services. Taxpayer contracts with the government and private entities.

The Department of Revenue ("Department") conducted an audit review of Taxpayer's business records and tax returns. As a result of that audit, the Department determined that Taxpayer owed additional sales/use tax. Taxpayer disagreed with a portion of that assessment and submitted a protest to that effect. An administrative hearing was held and a Letter of Findings (04-20091041.LOF) ("LOF") was issued sustaining Taxpayer's protest of issue five subject to the result of the supplemental audit review, sustaining Taxpayer protest to the ten-percent negligence penalty, and denying the rest of Taxpayer's protest. Taxpayer requested a rehearing on the "test cell equipment" and "generator" issues. The rehearing was granted and held. This Supplemental Letter of Findings ensues.

**I. Test Cell Equipment – Gross Retail Tax.**

**DISCUSSION**

Taxpayer operates a number of test cells. The test cells contain testing equipment. During the audit, the Taxpayer representative grouped its purchases into different categories—i.e., "manufacturing—direct," "multi-use," "manufacturing," and "fuel/oil" based upon the area of the plant where the items were used and/or the revenue designations used by the Taxpayer. The category that Taxpayer's representative entitled as "manufacturing" represented items used to generate the "engineering services and test cells" revenue from the test cells area of the plant. These items were purchased for use in the test cells. The Department's audit concluded that Taxpayer owed use tax on 71.50 percent of the total purchases that Taxpayer had included in this "manufacturing" category.

Taxpayer argues that these items purchased for use in the test cells are not subject to use tax because the items qualify for either – or both – the "manufacturing" and the "research and development" exemptions.

Pursuant to IC § 6-2.5-2-1, a sales tax, known as state gross retail tax, is imposed on retail transactions made in Indiana unless a valid exemption is applicable. Retail transactions generally involve the transfer of tangible personal property. IC § 6-2.5-4-1. A complementary excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction. IC § 6-2.5-3-2.

**A. Manufacturing Exemption.**

In this instance, Taxpayer invokes two exemptions; one of the exemptions is found at IC § 6-2.5-5-3(b). The exemption statute reads as follows:

Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for **direct** use in the **direct** production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property. (**Emphasis added**).

As a threshold issue, it is Taxpayer's responsibility to establish that the existing tax assessment is incorrect.

As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

In applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." *Indiana Dept. of State Revenue v. Kimball Int'l Inc.*, 520 N.E.2d 454, 456 (Ind. Ct. App. 1988). IC § 6-2.5-5-3(b) like all tax exemption provisions, is strictly construed against exemption from the tax. *Tri-States Double Cola Bottling Co. v. Dep't of State Revenue*, 706 N.E.2d 282, 283 (Ind. Tax Ct. 1999); *Mynsberge v. Dep't of State Revenue*, 716 N.E.2d 629, 636 (Ind. Tax Ct. 1999).

Taxpayer provided a number of examples of the activities which occur within the test cells.

[Taxpayer] received a current product engine from a client that was designed and produced to meet U.S. emissions regulations. [Taxpayer] was engaged to take this engine and custom manufacture a new engine that would meet the performance and emissions requirements for [a particular industrial] market. [Taxpayer] had to substantially change the existing engine configuration by removing the exhaust after-treatment system from the engine and make substantial changes to the entire computer algorithm. [Taxpayer] physically removed the after-treatment system from the engine and fabricated a new integral exhaust system. [Taxpayer] machined adapters to make the new exhaust system, welded components into the system, and assembled it onto the engine. Adjustments were made to the new hardware until the engine ran efficiently. Then [Taxpayer] began engine control module changes to reduce the exhaust emissions. Changes include engine timing, fueling and the fine tuning of the exhaust gas recirculation system in complex combinations.... At the conclusion of this project, the client will receive the newly manufactured engine and after treatment system that now meets the emissions requirements for [the particular industrial market].

A second example follows:

[Taxpayer] is engaged to manufacture a [fuel] exhaust system; specifically, a [] particulate filter package. [Taxpayer] must construct a filter which optimizes the filter/engine combination for compatibility. To do this, [Taxpayer] begins with a raw material substrate which [Taxpayer] fabricates to withstand high temperatures and resist corrosion, without hindering the performance properties of the substrate material. [Taxpayer] continues the process on the engine by assembling the appropriate combination of engine, after treatment components, and exhaust paths with the [] particulate filter. [Taxpayer] must then test the integrity of the parts produced. Results can repeatedly send [Taxpayer] back to the fabrication shop for modifications or a new build. Upon completion of a successful container build, [Taxpayer] produces the elements to complete the particular combination. The next steps include building a set of arrays within the engine control module, machining and assembling injectors for system regeneration, and creating a framework for the collective to interact. At the end of this manufacturing process, [Taxpayer] will deliver a complete engine system with an integrated exhaust after treatment component and controls that were made at [Taxpayer].

A third and final example follows:

[Taxpayer] is engaged to manufacture engine components that will withstand elevated temperatures and rapid temperature changes, subject to specifications provided by the customer. At the end of the project [Taxpayer] will provide a complete engine outfitted with specialty parts that have been manufactured by [Taxpayer] to endure the extreme temperature changes, along with documentation of [Taxpayer's] test to evidence that [Taxpayer] manufactured components withstood the specified temperature tests.

Above are instances in which Taxpayer utilized its "test cells" to develop engines or engine components. In these instances, Taxpayer was hired to develop a custom product which meets specific design and performance criteria. When Taxpayer is hired to make a custom product and that product it creates is transferred to its customer, Taxpayer is a producer/manufacture of that custom product. However, status as a manufacturer does not provide a blanket exemption for every purchase of property. For example, pre-production and post production activities are excluded from the "manufacturing exemptions." See [45 IAC 2.2-5-8\(d\)](#); [45 IAC 2.2-5-9\(d\)](#); [45 IAC 2.2-5-10\(d\)](#); & [45 IAC 2.2-5-12\(d\)](#). As part of Taxpayer's process it conducts "research and development" to get to that custom product. Research and development is a pre-production activity and property used for these activities are not exempt under the manufacturing exemptions. See [45 IAC 2.2-5-8\(j\)](#); [45 IAC 2.2-5-9\(j\)](#); [45 IAC 2.2-5-10\(j\)](#); & [45 IAC 2.2-5-12\(f\)](#).

The Department's audit did not entirely disagree with Taxpayer's contention that it was engaged in "manufacturing." As noted in the audit report, the Department assessed use tax on 71.50 percent of the total purchases that Taxpayer had included in this "manufacturing" category. Thus, the issue is the extent the activities performed using the property in the test cells constitute exempt manufacturing activities or constitute nonexempt activities.

Since Taxpayer uses this property for multiple purposes, a percentage of exempt use of the property will have to be determined. While the property in the test cells may be used part of the time for manufacturing, the property is also used for other nonexempt purposes. Besides using the property in the test cells to make custom products for its customers, Taxpayer also uses the property in its test cells to perform "services only" activities for customers. For example, Taxpayer performs research and development services on products that were developed by its customers. Taxpayer also performs engineering services for its customers. Taxpayer's uses of

the property in the test cells to perform these activities do not qualify for exempt uses under the manufacturing exemptions.

The audit division is requested to perform a supplemental audit to determine if the Taxpayer's exemption percentage for this property should be adjusted. Thus, Taxpayer's protest is sustained to the extent that the supplemental audit adjusts the exemption percentage of the property in the test cells. However, Taxpayer's protest is denied to extent that the supplemental audit does not adjust the exemption percentage of the property in the test cells.

The file will be returned to the audit division for the completion of a supplemental audit where the audit division will make the adjustments that it deems appropriate.

**B. Research and Development Equipment Exemption.**

Alternatively, Taxpayer argues it is entitled to the research and development exemption set out in IC § 6-2.5-5-40. That exemption provides a sales tax exemption "for research and development equipment purchased after June 30, 2007." Sales Tax Information Bulletin 75 (October 2008); (20081029 Ind. Reg. 045080815 NRA). IC § 6-2.5-5-40 provides as follows:

(a) As used in this chapter, "research and development activities" does not include any of the following:

- (1) Efficiency surveys.
- (2) Management studies.
- (3) Consumer surveys.
- (4) Economic surveys.
- (5) Advertising or promotions.
- (6) Research in connection with literary, historical, or similar projects.
- (7) Testing for purposes of quality control.

(b) As used in this section, "research and development equipment" means tangible personal property that:

(1) consists of or is a combination of:

- (A) laboratory equipment;
- (B) computers;
- (C) computer software;
- (D) telecommunications equipment; or
- (E) testing equipment;

(2) **has not previously been used in Indiana for any purpose**; and

(3) is acquired by the purchaser for the purpose of research and development activities **devoted directly to experimental or laboratory research and development** for:

- (A) new products;
- (B) new uses of existing products; or
- (C) improving or testing existing products.

(c) A retail transaction:

- (1) involving research and development equipment; and
- (2) occurring after June 30, 2007; is exempt from the state gross retail tax.

**(Emphasis added.)**

Accordingly, an exemption from sales and use tax is allowed for purchases of "research and development equipment" that occur after June 30, 2007. The research and development equipment exemption is available for equipment that "has not previously been used in Indiana for any purpose" and "is acquired by the purchaser for the purpose of research and development activities devoted directly to experimental or laboratory research and development." Id.

Taxpayer disagrees with the audit's conclusion that Taxpayer is not entitled to the research and development equipment exemption if the property purchased has a useful life of less than one year. The Department's position is set out at Sales Tax Information Bulletin 75 (October 2008) which states:

Research and development equipment means tangible personal property that consists of laboratory equipment, computers, computer software, telecommunications equipment, or testing equipment that has not previously been used in Indiana for any purpose and is acquired by the purchaser and devoted directly to experimental or laboratory research and development for new products, new uses of existing products, or improving or testing existing products. Research and development equipment does not include hand powered tools or property with a useful life of less than one year. (See also Sales Tax Information Bulletin 75 (September 2008) (20071003 Ind. Reg. 045070635 NRA)).

The rules of statutory construction require that exemption statutes be strictly construed against the Taxpayer. *Indiana Dep't of State Revenue v. Interstate Warehousing*, 783 N.E.2d 248, 250 (Ind. 2003).

In this situation, the audit applied the Department's policy as stated in Sales Tax Information Bulletin 75 (October 2008) and denied certain items because they were materials that had a useful life of less than one year and were "expensed." The Taxpayer argued that the statute concerning the research and development exemption did not differentiate between capitalized purchases and expensed purchases. The statute, however, sets out five groups of durable equipment that would be capitalized as research and development equipment exempt from the

sales tax. Several of the protested items are not durable property such as computers, software programs, laboratory equipment, telecommunications equipment, and testing equipment that will last over one year and be capitalized. The legislature specifically used the term "research and development equipment" and included only "equipment." The legislature did not see fit to include a category for materials that would be consumed within a year and were "expensed." If the legislature wanted these types of materials to be included in the exemption, the legislature would have enacted a statute similar to the provisions that were enacted for several other exemptions and credits. See IC § 6-2.5-5-4 (enacting a broad exemption using the general term of "tangible personal property" that is used to directly produce "machinery, tools, or equipment"). See IC § 6-2.5-5-1(b) (enacting a broad consumption exemption using the general term of "tangible personal property" that is consumed in manufacturing). See IC § 6-2.5-5-6 (enacting a broad incorporation exemption using the general term of "tangible personal property" that is incorporated in a manufactured product). See also IC § 6-2.5-5-3(b) (enacting an exemption for "machinery, tools, and equipment" that are used in direct production). See also IC § 6-3.1-4-1 (enacting a provision that broadly includes any "qualified research expense" in the adjusted gross income research expense credit). Since exemption statutes are strictly construed against the Taxpayer requesting the exemption, the Department is unable to expand the statutory definition of equipment to be used in research and development to include materials to be used and consumed in research and development. Therefore, Taxpayer's protest is denied to the extent that Taxpayer's protest includes such items that have a useful life of less than one year as the items do not qualify for the research and development equipment exemption pursuant to IC § 6-2.5-5-40.

Taxpayer also argues that the audit assessed tax on items in the test cells that have "a useful life of over one year." Taxpayer has a number of test cells and has used the property in the test cells for a variety of purposes. Taxpayer uses the test cell property to perform "testing services," to perform "engineering services," and to perform "custom manufacturing/production." As discussed previously, to qualify for the research and development equipment exemption the taxpayer must purchase "equipment" that "has not previously been used in Indiana for any purpose" and "is acquired by the purchaser for the purpose of research and development activities devoted directly to experimental or laboratory research and development."

The file is being returned to the audit division for the completion of a supplemental audit of the property used in the "test cells." Taxpayer's protest is sustained in part to the extent that the supplemental audit determines that Taxpayer has purchased "equipment" that "has not previously been used in Indiana for any purpose" and "is acquired by the purchaser for the purpose of research and development activities devoted directly to experimental or laboratory research and development." Taxpayer's protest is denied to the extent that the supplemental audit determines that Taxpayer has purchased "equipment" that has been "previously used in Indiana for any purpose," was not purchased for the "purpose of research and development activities," or was not "devoted directly to experimental or laboratory research and development."

In conclusion, Taxpayer's protest is denied to the extent that Taxpayer's protest includes such items that have a useful life of less than one year as the items do not qualify for the research and development equipment exemption. Taxpayer's protest is sustained in part to the extent that the supplemental audit determines that Taxpayer has purchased "equipment" that "has not previously been used in Indiana for any purpose" and "is acquired by the purchaser for the purpose of research and development activities devoted directly to experimental or laboratory research and development." Taxpayer's protest is denied to the extent that the supplemental audit determines that Taxpayer has purchased "equipment" that has been previously used in Indiana, was not purchased for the purchase of research and development activities, or was not devoted directly to experimental or laboratory research and development. The file will be returned to the audit division for the completion of a supplemental audit where the audit division will make the adjustments that it deems appropriate.

#### **FINDING**

Taxpayer's protest is denied in part and sustained in part subject to the results of a supplemental audit. As discussed in subparts A and B, the audit division is requested to perform a supplemental audit to determine if the Taxpayer's exemption percentage for this property should be adjusted from the 29.5 percent that was granted in the audit. Thus, Taxpayer's protest is sustained to the extent that the supplemental audit adjusts the exemption percentage of the property in the test cells. However, Taxpayer's protest is denied to extent that the supplemental audit does not adjust the exemption percentage of the property in the test cells. As discussed in subpart B, Taxpayer's protest is denied to the extent that Taxpayer's protest includes such items that have a useful life of less than one year as the items do not qualify for the research and development equipment exemption.

#### **II. Electrical Generator – Gross Retail Tax.**

#### **DISCUSSION**

The Department's audit assessed use tax on the price paid for an electrical generator. As explained by Taxpayer, "[T]he audit denied the Industrial Exemption and R & D Exemption on a generator purchased by [Taxpayer] for use in the test cells because the generator would also be available as a contingent back-up generator for future data storage." Taxpayer indicates that it intends to use the generator for multiple purposes. Taxpayer indicates that the generator would be available as a backup power source and "will be used for two research projects in the test cells." Taxpayer further explains the generator will "be used as a backup power

source about 10 hours per year" and will be used about "one hundred hours a year" as a backup power source for the test cells." Taxpayer also explains that the generator "will be used for two research projects conducted in the test cells."

Since Taxpayer uses this property for multiple purposes, a percentage of exempt use of the property will have to be determined. Taxpayer's use of the generator in two research projects would not qualify for exemption. See IC § 6-2.5-5-40(b) (providing that to qualify for the exemption the taxpayer must show that the equipment "has not been previously used in Indiana for any purpose," was not purchased for the "purpose of research and development activities," or was not "devoted directly to experimental or laboratory research and development.") Taxpayer's partial use of the generator as a back-up power source would qualify for an exemption to the extent that the power source qualifies for an exemption.

The audit division is requested to perform a supplemental audit to determine to what extent Taxpayer's use of the generator qualifies for an exemption. Taxpayer's protest is sustained to the extent that the supplemental audit determines the generator qualifies for an exemption. However, Taxpayer's protest is denied to extent that the supplemental audit determines the generator does not qualify for an exemption. The file will be returned to the audit division for the completion of a supplemental audit where the audit division will make the adjustments that it deems appropriate.

#### **FINDING**

Taxpayer's protest to the imposition of use tax on the generator is denied in part and sustained in part subject to the results of a supplemental audit.

#### **SUMMARY**

As set out in Issue I, Taxpayer's protest is denied in part and sustained in part subject to the result of the supplemental audit review. As discussed in Issue I subparts A and B, the audit division is requested to perform a supplemental audit to determine if the Taxpayer's exemption percentage for this property should be adjusted from the 29.5 percent that was granted in the audit. Thus, Taxpayer's protest is sustained to the extent that the supplemental audit adjusts the exemption percentage of the property in the test cells. However, as discussed in Issue I subparts A and B, Taxpayer's protest is denied to extent that the supplemental audit does not adjust the exemption percentage of the property in the test cells. As discussed in Issue I subpart B, Taxpayer's protest is denied to the extent that Taxpayer's protest includes such items that have a useful life of less than one year as the items do not qualify for the research and development equipment exemption. As set out in Issue II, Taxpayer's protest to the imposition of use tax on the generator is denied in part and sustained in part subject to the result of the supplemental audit review that determines the extent the generator qualifies for an exemption.

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